

# When and how to unwind COVID- support measures to the banking system?

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## **Abstract**

Designing exit strategy requires judgment, coordination among different institutions, and graduality. Restoring banks' balance sheet transparency is a first-order objective. To this end, borrower relief measures should be phased out ahead of the other measures. Relaxation of loan classification and provisioning policies can be lifted in a second stage. The last one to be unwound would be capital relief initiatives. To provide banks time and space of manoeuvre, exit strategies needs to be communicated in a clear and timely manner.

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## LIST OF ABBREVIATIONS

<b>AMC</b>	Asset Management Company
<b>BRRD</b>	Bank Recovery and Resolution Directive
<b>CCB</b>	Capital Conservation Buffer
<b>CCyB</b>	Countercyclical Capital Buffer
<b>CET1</b>	Common Equity Tier 1
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>EU</b>	European Union
<b>GDP</b>	Gross Domestic Product
<b>NPLs</b>	Non-performing loans
<b>IFRS</b>	International Financial Reporting Standards
<b>LCR</b>	Liquidity Coverage Ratio
<b>PEPP</b>	Pandemic Emergency Purchase Programme
<b>PGS</b>	Public Guarantee Scheme
<b>P2G</b>	Pillar 2 Guidance
<b>P2R</b>	Pillar 2 Requirement
<b>SREP</b>	Supervisory Review and Evaluation Process
<b>SRM</b>	Single Resolution Mechanism

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## EXECUTIVE SUMMARY

The outbreak of the COVID-19 crisis triggered the adoption of extraordinary measures to support the economy and maintain banks' ability to provide funds to the economy. The interventions have included a wide set of monetary, fiscal, regulatory and supervisory measures for the banking sector.

The combined effect of these measures has created a virtuous circle between corporates, banks, and sovereigns. Due to the higher level of debt at governments and corporates, it also created the premise for increased systemic risk.

Understanding the effect of COVID related policy response on bank balance sheets is important to design a balanced exit strategy. To this end, the paper examines the support measures deployed so far, placing emphasis on those affecting bank lending more directly, i.e., moratoria on loan payments, public guarantees, and capital relief measures. These measures will be discussed having in mind their potential drawbacks and the way they can distort banks' and borrowers' incentives.

In designing the exit strategies, re-establishing the preconditions for banks' balance sheet transparency should be a first-order objective. The benefits of transparent balance sheets are multiple and go hand in hand with the possibility to measure banks' asset quality and thus, assess the amount of capital at risk. As opaque balance sheets increase bank funding constraints, transparent and comparable balance sheets would also make it possible for banks to return to capital markets for funding when the extraordinary monetary policy measure will be removed.

Having this in mind, borrower relief measures should be phased out ahead of the other measures. Once this goal is accomplished, measures to relax loan classification and provisioning policies can be lifted as well. The last one to be unwound would be capital relief initiatives.

Of course, unwinding support measures requires graduality and flexibility, depending on the evolution of the pandemic and its impact on different firms and industries. For example, certain firms or industries may need prolonged forms of support, which however need to be designed accurately to mitigate the risk of moral hazard on the part of businesses and evergreening on the part of banks.

After the crisis, certain banks may display markedly reduced capital buffers and certain firms may be found unviable. Thus, the unwinding process requires cooperation at national and supranational levels, and across multiple institutions, including the Single Resolution Mechanism (SRM). It might also require out-of-the box solutions in case of more widespread corporate and banking fragility overwhelming existing frameworks.

Finally, exit strategies need to be communicated clearly and in a timely manner, so as to enable banks sufficient time to make plans and adjust their balance sheets accordingly.

## 1. INTRODUCTION

The COVID-19 pandemic is fundamentally affecting economies around the world. In an attempt to contain the spread of the virus, governments have implemented measures that limit mobility and restrict economic activity. Containment measures and changes in behaviour have led to a sharp reduction in economic activity. Non-financial firms in sectors hit by the pandemic have faced losses and liquidity contraction. Households' income and net worth have also been affected, as firms have reduced wages or laid off workers.

At the same time, the swift and comprehensive policy response, combined with the fact that COVID-19 vaccines have become available, has reduced the risk of the most severe scenarios. Fiscal policy measures have supported the liquidity and solvency of the real economy and thus, indirectly, the financial sector. Monetary policy has stabilised asset prices and maintained favourable funding conditions for banks and corporates. Moreover, the financial system was relatively resilient at the onset of the pandemic due to the regulatory reforms implemented in the aftermath of the global financial crisis (GFC). Compared to the years leading up to the GFC, banks are now better capitalised and supervisors have used the flexibility of the new regulatory framework to allow banks to draw on their capital buffers (ESRB, 2021).

So far, backed by government support, monetary policy and regulatory easing, the financial system has continued to provide funding to the real economy and losses in banking books have been contained. Thus, a benign loop between corporates, banks, and governments has been created. However, the long-term implications both in terms of economic growth and financial stability implications still need to be monitored. In particular, certain policy measures such as moratoria on loan repayments, if prolonged for too long, may pose future risk on borrowers' as well as banks' balance sheets.

Deciding how and when to exit from relief measures is certainly a great challenge. Acting too early may induce a credit crunch and impede the economy recovery. Waiting too long could create the premises for undesired feedback loops among the sovereigns, banks, and the real economy and, thus, heighten systemic risks. Making the right calls at the right time will require judgment and caution as well as coordination among different, national and international, institutions. To contribute to the discussion on when to unwind the extraordinary support measures and how, we first summarize the main policy responses to the pandemic. While distinguishing among monetary, fiscal, and regulatory and supervisory measures, we take a closer look at those affecting bank lending more directly, i.e., borrower relief measures (e.g., moratoria on loan repayments and public guarantees) and bank capital relief measures. We examine these measures in order to understand the implications for banks' balance sheets of their prolonged usage. We then discuss the pros and cons of exit strategies and propose a pattern to gradually unwind the different measures as societies emerge from the threat of the pandemic.

## 2. THE POLICY RESPONSE TO THE PANDEMIC

### 2.1. Overview

The outbreak of the COVID-19 crisis triggered the adoption of extraordinary measures to support sovereigns, corporates and households and maintain banks' ability to provide funds to the economy. The overall objective was to prevent that a temporary shock would have long standing consequences on the economy. The interventions have included a wide set of monetary, fiscal, regulatory and supervisory measures for the banking sector that are summarised below.

Monetary policy measures. They entailed three main initiatives primarily aimed to support funding capacity of sovereigns, banks, and (to a lesser extent) corporates.

First, the ECB reinforced asset purchases and introduced the €1,850 billion pandemic emergency programme purchase for public and private sector assets (PEPP). Between March 2020 and January 2021, the Eurosystem purchased €810 billion of assets under the PEPP, 95% of which consisted of public sector securities. As for the private sector component, this is mainly composed of corporate bonds and commercial papers. However, there is a substantial degree of flexibility embedded in the PEPP, allowing for fluctuations in the distribution of purchase flows over time, across asset classes, and among jurisdictions (see EP, 2021, for updated and concise description of ECB's monetary policy measures).

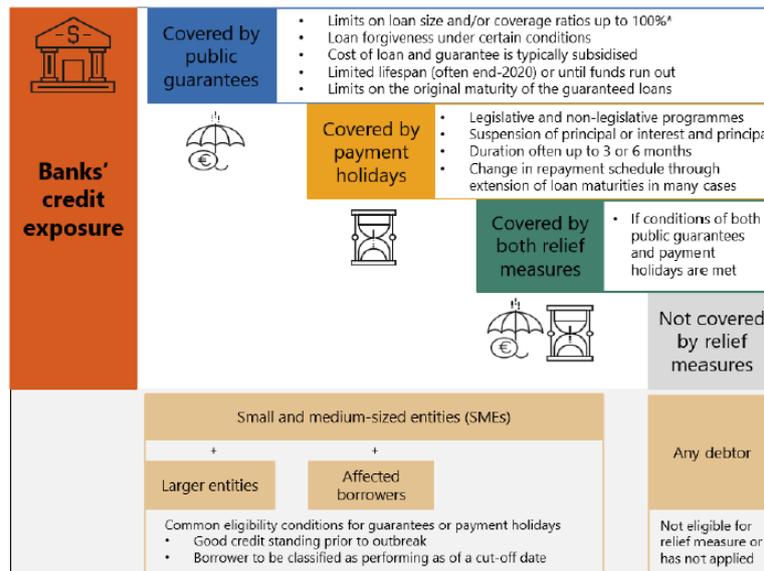
Second, the ECB enhanced its long-term refinancing operations (with financing conditional on banks extending credit to businesses), by increasing the liquidity injected, extending (to June 2022) the period over which considerably more favourable terms would apply, and easing the collateral framework. Third, the ECB decided to keep the key interest rates unchanged, i.e., at a historically low level.

All in all, the policy measures have been conceived to help the economy absorb the shock of the crisis and support access to finance of corporates and households by relaxing banks' funding constraints. As of December 2020, the ECB decided to prolong the duration these measures to around March/June 2022, depending on the measure.

Fiscal policy measures. They included a package of national and supranational interventions to help the overall economy as well as specific types of firms (e.g., small-medium size enterprises, SMEs) or sectors to weather the COVID-19 shock.

At the national level, the range of aid schemes has been wide. Some measures compensated firms for the containment measures enforced to close businesses or reduce economic activity. For example, government-sponsored job retention programs allowed firms to adjust working hours and reduce the wage bill, while maintaining employment. Government grants to firms were used to compensate firms for specific fixed costs such as rents or interest on loans. They often targeted smaller firms and the self-employed or firms with large revenue losses. Aid was sometimes granted in the form of tax cuts or deferrals, and payment advantages particularly for hard-hit sectors. For strategic firms whose exit would have a significant impact on the economy (e.g., national airlines), solvency support measures such as equity instruments and hybrid capital instruments were also used. National measures also included borrower relief measures such as public guarantee schemes (PGSs) and moratoria on loan repayments. The former are intended to preserve incentives for banks to grant new loans by shifting risk, at least partly, to the public sector, the latter to provide financial breathing space to cash constrained borrowers. Both types come in various forms, as illustrated in Figure 1.

**Figure 1: Key features of borrower relief measures**



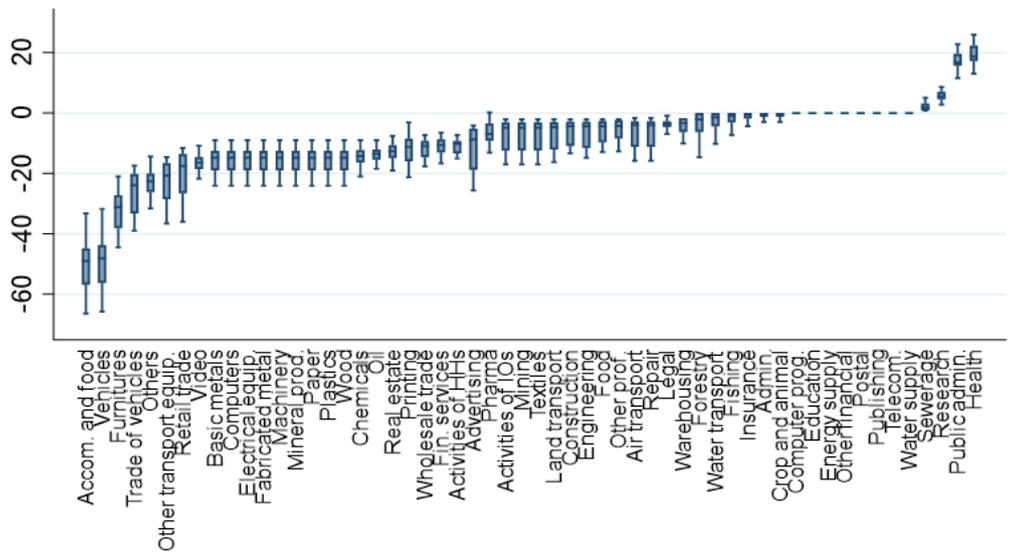
Source: Ehrentraud and Zamil (2020).

The overall government support packages related to the pandemic amount to about 14% of GDP in Europe based on information available up to September 2020 (ESRB, 2021). As we discuss also further below, by September 2020 the reported uptake of these programmes was over €700 billion (roughly 4% of GDP), with more than €400 billion of loans with public guarantees. In addition, more than €840 billion of loans (around 5% of banks' total loans) were subject to moratoria. Importantly, fiscal measures exhibited large discrepancies in scope, size, and conditions across countries.

Several factors help explain this variety. The impact of the crisis was asymmetric, with some countries hit harder than others and/or before others. The resulting shocks to economic activity also depended on the evolution and severity of containment measures across essential and non-essential sectors, on whether revenues are recoupable (e.g., construction sector) or not (e.g., food services), and whether they are affected by permanent shocks to consumer behaviour (e.g., travel) or not.

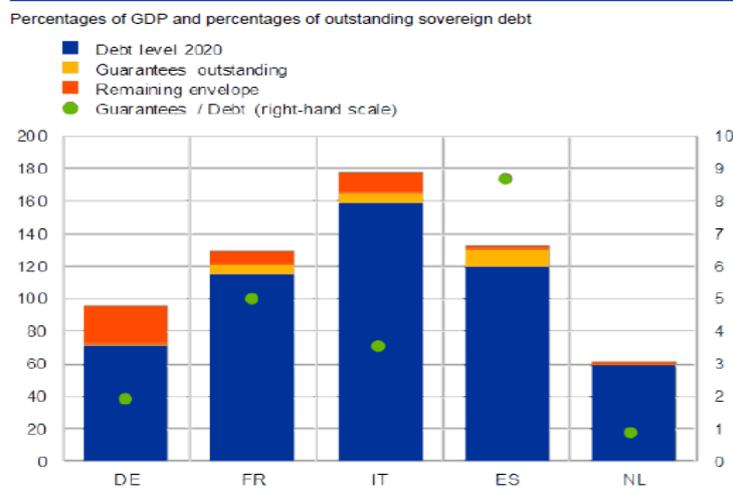
Figure 2 shows the significant cross-sectoral and cross-country variation worldwide, where the boxes and whiskers represent the dispersion of growth of each sector across countries. Fiscal capacity also differs remarkably, and so does therefore the government response. Figure 3 shows the intensity of interventions (guarantee outstanding in proportion of national GDP) and the remaining envelopes (in proportion of sovereign debt) in selected euro area countries.

**Figure 2: Pandemic shock: output growth rates in 2020 by sector across countries (in percent)**



Source: IMF staff calculations (Ebeke et al., 2021).

**Figure 3: Loan guarantees and remaining envelope in selected euro area countries**



Sources: National authorities and ECB calculations.  
 Notes: Data are based on national sources and cover guarantees committed or announced until the end of 2020. "Remaining envelope" denotes announced envelopes of guarantees that have not yet been committed.

Source: Schnabel (2021)

In terms of supranational measures, owing to the exceptional circumstances, European Union (EU) state aid rules were modified to allow member states to support their economies by means of direct or indirect interventions. Along with a reinforced EU 2021-2027 budget, on March 2020 member states also agreed on a temporary € 750 billion recovery fund financed by resources that the EU borrows directly. The European Commission has recently decided to prolong and extend the temporary framework, an important step to counterbalance the limited resources of member states. To protect jobs, it is also available for member states that need to mobilise significant resources to supporting short-time work schemes and similar measures. As part of the overall EU COVID-19 response package, a specific temporary measure to protect jobs is SURE (i.e., Support to mitigate Unemployment Risks in an Emergency). This scheme provides financial assistance up to €100 billion in the form of loans from the EU to member states to address sudden increases in public expenditure for the preservation of

employment. Extraordinary financial aid to corporates has also been provided by the European Investment Bank Group, whose plan is to mobilise up to €200 billion to support mostly small and medium-sized enterprises through different schemes.

Prudential and supervisory measures. The last leg of COVID-related policy measures dealt with the banking authorities' decisions to provide operational relief to banks, primarily by allowing the usage of capital and liquidity buffers and by relaxing loan classification criteria and loan loss provisioning practices (ECB, 2021).

In an attempt to prevent procyclicality, capital and liquidity relief measures, in particular, were introduced in March 2020 to enable banks to operate *temporarily* below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR). Banks were also allowed to partially use capital instruments that do not qualify as Common Equity Tier 1 (CET1) capital, such as Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R).<sup>1</sup> According to ECB's estimates, capital measures would provide banks with an aggregate relief of around €120 billion that would make them able to grant up to €1.8 trillion of loans to households and corporates (ECB, 2021). In return, banks were asked not to distribute profits in the form of dividends or share buy-backs and be conservative in variable remuneration.<sup>2</sup> Banks may fully use capital buffers, including Pillar 2 guidance, until at least the end of 2022. Several national competent and designated authorities also reduced countercyclical capital buffers (CCyBs) to zero.

To complement capital relief measures, in contrast with the approach followed in the United States, the 2020 stress tests and the verification of compliance with qualitative supervisory review and evaluation process (SREP) measures were postponed, and only a vulnerability analysis was conducted by the single supervisory mechanism (SSM) in December 2020. In January 2021, the EBA launched the 2021 EU-wide stress test "to provide input for assessing the resilience of the European banking sector during the pandemic crisis". Consistently, the adverse scenario is based on a narrative of a prolonged COVID-19 scenario in a "lower for longer" interest rate environment, in which negative confidence shocks would prolong the economic contraction. The EBA expects to publish the results of the exercise by 31 July 2021.

An accurate description of the extraordinary measures deployed in Europe is available in ESRB (2021).

## 2.2. Effectiveness of the policy response

### 2.2.1. The COVID-19 narrative: virtuous circle, but for how long?

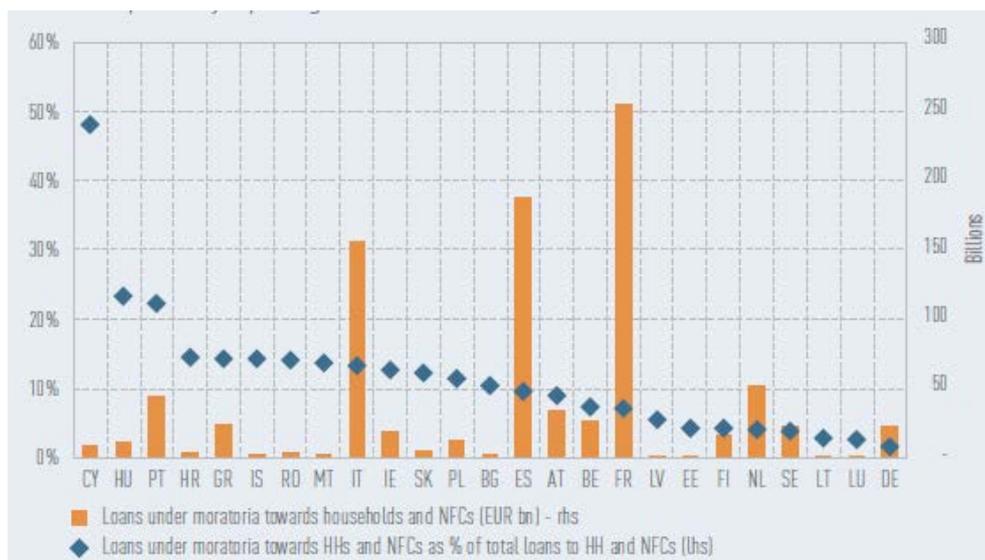
As discussed, at the onset of the pandemic, the strict lockdown hit several parts of the corporate sector hard to a degree not seen since the global financial crisis. Corporates' revenues collapsed and firms faced acute liquidity shortages. In the early stages of the COVID-19 outbreak, corporates, especially SMEs could make use of available loan commitments to secure liquidity and operational continuity. In a second stage, governments and policy makers stepped in with a broad array of actions to limit the economic damage from the pandemic. Unlike the global financial crisis, bank lending to the real sector has increased (during the second quarter of 2020 the year-to-year increase of banks' assets amounted to 7%, according to EBA, 2020a). Thanks to borrower relief measures, banks were able to increase their exposures to sectors most affected by confinement measures (Figures 4 and 5).

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<sup>1</sup> In doing this, the ECB has brought forward a measure that was initially scheduled to come into effect in January 2021, as part of the latest revision of the Capital Requirements Directive - CRD V.

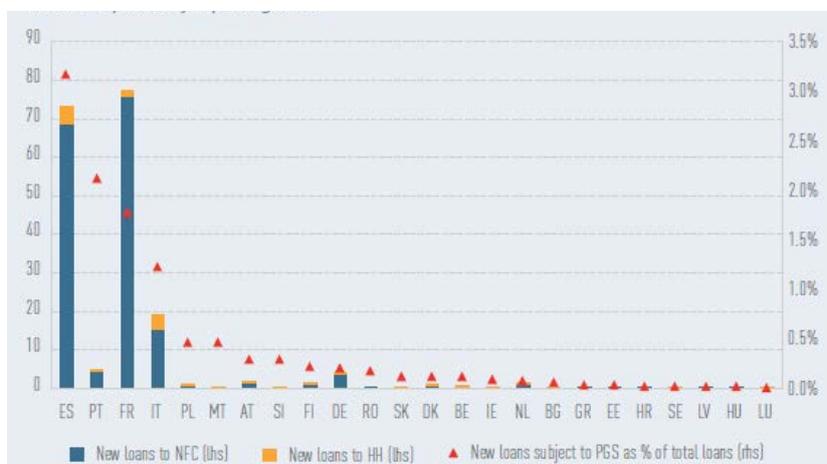
<sup>2</sup> Specifically, the ECB asks banks not to pay dividends and not to buy back shares until January 2021, and be "extremely moderate with regard to variable remuneration". This request was extended and amended in December 2020 until September 2021, with limits on dividend payments.

Figure 4: Loans to households and non-financial companies under moratoria (€ bill and as percentage of total loans to HHs and NFC, by country, June 2020)



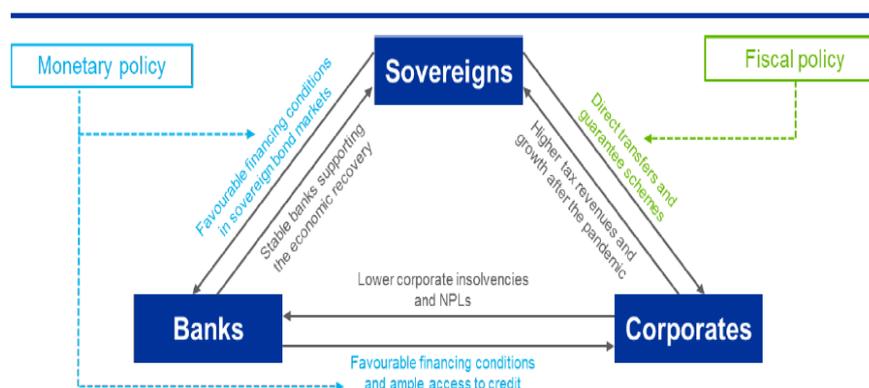
Source: EBA supervisory reporting data (EBA, 2020a)

Figure 5: New loans backed by PGSs (€ billion) by country, June 2020



Source: EBA supervisory reporting data (EBA, 2020a)

At the same time, the ECB supported bank lending to firms by providing ample liquidity at favourable conditions, while prudential authorities took comprehensive supervisory relief measures. Overall, the combined effect of these measures created a virtuous circle between corporates, banks, and sovereigns, as depicted in Figure 6. At least in the short term, employment was shielded, income and aggregate demand were stabilized, and corporate defaults were contained. This has proven beneficial to banks as well. Borrower relief measures, combined with monetary policy and supervisory initiatives, have further enabled banks to provide credit, liquidity and other financial services to the economy, which restarted the benign loop between corporates, banks, and sovereigns. But for how long?

**Figure 6: The virtuous circle among sovereigns, banks, and corporates**

Source: Schnabel (2020)

There are concerns that the tight interlinkages resulting from the broad support combined with the increased corporate and sovereign debt may turn the virtuous circle into a vicious embrace (Schnabel, 2021; EBA, 2020a). As long as corporate health is dependent on government support, the withdrawal of such a support may trigger corporate defaults that in turn can result into higher NPLs. A sudden rise in NPLs would threaten banks' stability and put even more pressure on sovereigns, which may trigger government bonds downgrade. Because of the increased banks' exposures to sovereigns, a feedback loop (from sovereign to bank risk) can also be activated.<sup>3</sup> The fact that banks have not only increased their exposures to sovereign bonds but also extended new loans secured by government guarantees would make the scenario even more worrying.

Hence, understanding the effect of COVID related policy response on bank balance sheets is important to design a mindful exit strategy. Acting too early may impair economic growth, while waiting too long could heighten systemic risk and make vicious feedback loops more likely.

Against this background, the goal of this section is to examine the policy measures that have had a more direct impact on banks and their ability to provide credit to the economy. The focus will be on borrower relief measures (namely, moratoria on loan repayments for borrowers in financial difficulties and PGSSs), and prudential and supervisory measures.

### 2.2.2. Borrower relief measures: Intensity of usage and side effects on bank balance sheets

As discussed in Section 2.1, since March 2020 member states have introduced borrower relief measures to mitigate the impact of the sudden halt in economic activity, by either providing breathing space to borrowers or supporting new lending.

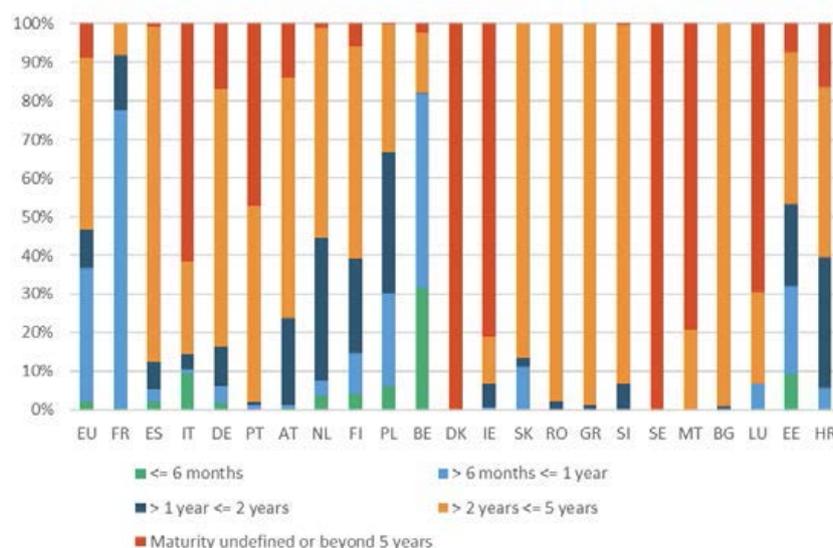
- Moratoria on loan repayments. According to the EBA (EBA, 2020b), as of June 2020, over €870 billion of loans (i.e., 6% of European banks' total loans) were subject to moratoria on loan repayments (Figure 4). Most of payment holidays were granted to corporates, especially SMEs (9% of corporate loans had a payment break and around 16% of the SME exposures were granted moratoria – the largest share across all segments). The use of moratoria was widely dispersed across countries (e.g. in Central and Eastern Europe moratoria were automatically applied to all borrowers, in most others, instead, borrowers had to apply for them) and banks (e.g., Cypriot banks reported the highest share of loans subject to moratoria) and most of them (around 85%) expired before December 2020, i.e., had a maturity below 6 months (EBA, 2020a). However, certain countries (e.g., Italy) have recently announced the automatic extension of the support. Likewise, in December 2020 the EBA decided to reactivate its guidelines on moratoria

<sup>3</sup> The sovereign exposure in EU banks in December 2019-2020 increased by 11%. In the first two quarters of 2020, banks in France reported the largest increase in sovereign exposures (EUR 172 billion or 19%), followed by Italy (EUR 57 billion or 14%) and Germany (EUR 45 billion or 9%). EBA (2020a).

to ensure that loans, which had previously not benefitted from payment holidays, could also take advantage of them in the near future.

- PGSs. As of June 2020, newly originated loans subject to PGSs amounted to €181 billion, representing 1.2% of banks' total loans (Figure 5). The vast majority (95%) of public guaranteed loans were granted to corporates. The use of PGSs was widely dispersed across banks and countries in Europe. The scheme was absent or limited in most European countries, with the exception of Spain, Portugal, France and Italy (EBA, 2020b). PGSs tend to have longer maturities than moratoria. Around 44% of these loans had guarantees in place with a residual maturity of between 2 and 5 years, while another 34% of loans benefitted from guarantees with a residual maturity between 6 months to 1 year (Figure 7), resulting in a longer-term effect of PGSs (vis-à-vis moratoria) on banks' balance sheets.

**Figure 7: Residual maturity of public guarantees by country – June 2020**



Source: EBA supervisory reporting data (EBA, 2020b)

Overall, the borrower relief measures have been beneficial to banks in several ways. By shifting risk from banks to governments, PGSs have reduced bank risk-weighted assets (RWAs). The risk mitigation effect is remarkable: on average, banks reported the RWAs to be 18% of the exposure value for loans subject to PGSs, as opposed to an average risk weight of 54% for “standard” corporate loans (EBA, 2020a). It follows that the deployment of PGSs has contributed to enhance (risk based) regulatory capital ratios. The risk reduction is also associated with lower expenses due to reduced loan loss provisions but also reduced bank profit margins. In addition, on the negative side, a wide usage of PGSs can amplify banks' exposure to sovereign risk, potentially reinforcing the loop illustrated above.

As for moratoria on loan repayments, the expected (short run) effect is that of mitigating rollover and default risks, especially in the SME category, while also reducing, at least temporarily, interest revenue. There are, however, long-term side effects that need to be taken into account. First, the break given to borrowers is only temporary as deferred payments must be repaid later. Depending on the evolution of borrowers' creditworthiness, this may increase future risks for banks.<sup>4</sup> Second, prolonging moratoria may increase systemic risk, either because borrowers (including the viable ones) may develop a “non-payment” culture, or because of a cliff effect at the expiration of moratoria, which might induce a sudden increase in the level of non-performing loans (NPLs). Third, prolonged moratoria may reduce

<sup>4</sup> This risk is material, as EBA reporting data show that around 17% of loans under moratoria were classified as stage 2, which is more than double the share for total loans. The NPL ratio for loans subject to moratoria was 2.5%, slightly lower than the EU average of 2.9% for all loans. This, however, is expected, as many schemes allowed only performing loans to make use of moratoria. (EBA, 2020b).

bank balance sheet transparency, which would threaten the ability of investors to exert market discipline and of supervisors to monitor banks. To explain the mechanism, the lack of periodical payments is likely to make monitoring more complicated, as banks would find it harder to distinguish between viable and non-viable borrowers in the absence of periodical cash flows for both borrower categories. This may have an impact on (specific) provisioning policies that rely on borrowers' payment history, although this may be compensated, at least partly, with a proper accumulation of generic provisions. Delayed and inadequate provisioning for too long would not only be detrimental to balance sheet transparency; it would also impair bank lending (see, e.g., Laeven and Majnoni 2003). Likewise, it would be more difficult for banks to ascertain when credit risk has increased *significantly*, a precondition for loans to be classified in the so-called stage 2, according to the International Financial Reporting Standard (IFRS) 9.

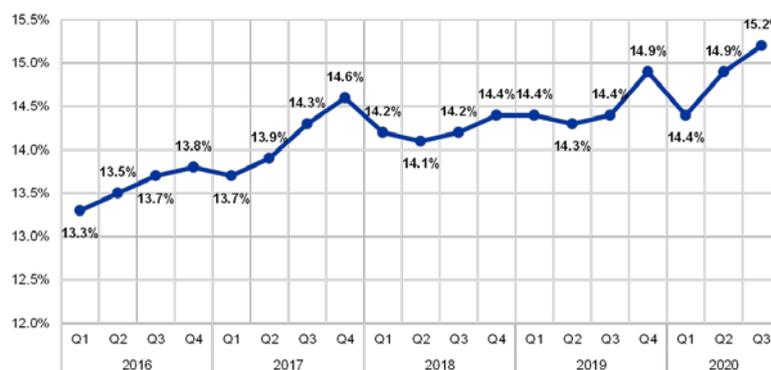
To limit these drawbacks, the banking authorities started requiring in fall 2020 banks to carefully assess loans under moratoria in order to tackle the foreseen deterioration of asset quality more effectively at the expiry of the borrowers' relief measures. It remains however that weaker (undercapitalised or unprofitable) banks may have greater incentives to underreporting and underprovisioning, as found in previous research (see, e.g., Ristolainen, 2018).

### 2.2.3. Capital relief measures: Intensity of usage and criticisms

Contrary to what happened during the global financial crisis, euro area banks have reinforced their capital positions since the beginning of the pandemic. In December 2019, the average CET1 ratio of institutions directly supervised by the ECB stood at 14.9%; one year later the CET1 ratio had increased to 15.2% (Figure 8).

More recent data (see, e.g., the outcome of 2020 SREP released by the ECB as of end of January 2021) confirms that overall ample capital buffers remain unused. There are, however, signals of greater usage compared to previous quarters. In particular, 2020 SREP aggregate results show that nine banks are making use of capital relief measures, with CET1 levels based on the third quarter of 2020 below (and in some cases, well below) the CET1 requirements and guidance prior to the COVID-19 measures.<sup>5</sup>

**Figure 8: Quarterly developments of CET1 ratio**



Source: 2020 SREP aggregate results

All in all, evidence on the aggregate level shows that capital buffers' utilisation has been limited. This suggests that supervisory and regulatory measures, such as restrictions on dividend payments and reduced RWAs due to credit guarantees, have helped enhance capital ratios. However, it also prompts

<sup>5</sup> Chart 24 in the ECB's presentation of the SREP 2020 results shows that five of these banks have reduced their buffers quite significantly. The report however does not clarify whether the capital buffers have been used to absorb losses or expand the loan portfolio.

questions on the “effectiveness” of capital relief measures. In other words, what explains the limited usage of capital buffers?

An immediate reply is that, given the high levels of capital and liquidity banks have on average, there was no real need for them to make use of the capital and liquidity relief measures. Yet, as argued (Andreeva et al., 2021; Behn et al., 2020), what is worrisome is that although capital buffers are intended to be used as shock absorbers, there are a number of factors that may undermine banks’ willingness to accept a decline in capital or liquidity ratios. Many of these factors relate to stigma emerging from the breach of capital buffer requirements or when banks’ capital ratios fall below market expectations. Pressure from financial markets could be important explanatory factors of the limited use of capital buffers. Equity investors would expect banks to continue dividend payments rather than to use excess capital to lend or to absorb losses. Bondholders may require banks to maintain higher capital ratios to reduce default risk and avoid rating downgrades. In this last respect, the fear of higher funding costs associated with a decline in capital ratios can refrain banks from using capital buffers. Such an effect might be amplified if capital depletion goes hand in hand with lending growth, which, in times of crisis, may be suggestive of excessive risk-taking.

Supervisory and regulatory factors may provide further incentives to limit capital buffer’s utilization. Anecdotal evidence shows that banks, in order to preserve relationship with investors, prefer to de-risk and deleverage rather than face automatic restrictions (on dividends and bonus) triggered when bank operate below the combined buffer requirements. In this view, maintaining a regular stream of dividend payments would be even more important in harsh times to signal that dividends are not jeopardized, but only delayed and ready to be distributed as soon as the COVID-related restrictions are lifted (Matyunina and Ongena, 2020).<sup>6</sup>

Moreover, banks may want to avoid the increased supervisory scrutiny that is likely to be associated with buffer depletion.<sup>7</sup> In addition, although banking authorities reported that banks will be informed of supervisory expectations and the results of the EBA’s stress test in 2021 could provide some clarity on the rebuilding of capital buffers, banks may still face uncertainty, for example with respect to the time they would have to restore their buffers after the initial breach of the requirements. This calls for a clear communication of supervisory expectations that should be set in order to give banks sufficient time to restore their capital buffers

A related question is whether the current macroprudential framework is adequate for banks to act countercyclically. Some authors argue that the CCyB is better suited than other macroprudential buffers to address cyclical stress (Darracq Pariès et al., 2020). However, the amount of the CCyB was 0% in most jurisdictions in Europe in February 2020, making the macroprudential space of the intervention limited almost by definition. More generally, the question arises whether macroprudential tools such as capital requirements are as effective in crisis periods as they are in boom periods. As argued (see EBA, 2020a), as the pandemic provides the first case of use of the buffer framework, the lessons learnt could also inform a potential redesign if deemed necessary.

Given the uncertain evolution of the crisis, precautionary reasons could also explain the current limited usage of capital buffers. Supervisory data (see EBA, 2020a) already show signs of deterioration in asset quality, such as elevated cost of risk on performing loans, increasing volumes of forbore loans, and a migration of assets to stage 2 under IFRS9. Although NPLs and stage 3 loans are still stable, a substantial deterioration in asset quality is expected in the quarters to come. Banks may be concerned about the actual possibility to access capital market and restore capital buffers once economic conditions normalize, especially in a context of high NPLs.

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<sup>6</sup> Interestingly, the restrictions are not extended to AT1 instruments. Even if coupon payments are contractually set to be discretionary, market intelligence suggests that a cancellation of a coupon payment for these hybrid bonds could be seen as a particularly adverse signal (Behn et al., 2020), perhaps because cancelled AT1 coupon payments cannot be paid out later. This exemption could raise some concerns on the actual loss absorption capacity on a going-concern basis of AT1 instruments.

<sup>7</sup> According to the ECB, significant uncertainties remain in the short to medium term and SREP data indicate an ongoing need for vigilance and continued supervisory challenges in several critical areas, relating in particular to the risk of a sudden increase in NPLs.

### 3. WHEN AND HOW TO UNWIND?

As policymakers, including regulators, consider an exit strategy from the different support measures, one critical point to keep in mind is that there are important interactions between the different measures, both in their support for economies and societies and in their effect of being phased out. This calls for coordination in the exit strategy, which in turn is more difficult as it requires coordination between different institutions and policy levels. First, fiscal support measures are almost exclusively national, while supervisory measures are either supranational (as in the case of the SSM) or at a minimum coordinated at the European level (as in the case of the ESAs and ESRB). Second, as we will discuss below, exit measures and the consequent recognition of losses might result in the need for restructuring and resolution measures, which would require the need for closer coordination, for example, between supervisory and resolution authorities. Finally, there is the need to take into account what other major non-EU economies are doing (e.g., UK, US). Another critical challenge is the timing. While support measures were put in place swiftly, even without immediate cooperation, it is not obvious ex-ante, at what point the support measures should be withdrawn and doing so thus requires careful cooperation.

At the core of the exit strategy lies the tension between “Keynes” and “Schumpeter”. On the one hand, and as discussed above, support measures were put in place to help firms and households affected by the economic consequences of the public health shock. At the same time, continuous support can be justified with the attempt to avoid hysteresis, i.e., the risk that the current severe economic downturn and consequent high unemployment (in absence of support measures) cause unemployed individuals to lose their job skills or become demotivated, turning into high rates of long-term or structural unemployment. Such scarring effects would hamper not only economic recovery but ultimately result in longer-term growth rates. Similar arguments can be developed for other economic input, such as commercial real estate and manufacturing capital. Such hysteresis effects do not only damage affected individuals but also permanently reduce potential output, thus reducing long-term growth perspectives. This is not only challenging from macroeconomic perspective, but also from social and political viewpoints. Supporting firms and people is thus the first priority – through such support, pressure is also being relieved on banks.

On the other hand, the pandemic will have (possibly permanently) changed the returns on activity in different sectors and industries. There is thus a need for reallocation of resources within the economy post-pandemic. This requires a process of “creative destruction”, where some firms, even if viable before the outbreak of the pandemic, may have to undertake a profound transformation towards new products, services and/or markets, and new firms are created in sectors and industries with growth opportunities. Such a process would be impossible, if support measures keep all firms in their current structure alive, independent of whether they are viable in their current structure in the long-run or not. Capital and labour would be tied in such firms and reallocation thus impossible.

At the core of this tension is uncertainty. At this stage, there is no clear exit trajectory from the public health crisis. While the introduction of different vaccines has provided hope, their effectiveness against further mutations is unclear as is the point when Covid-19 is no longer to be regarded as pandemic but limited to local and possibly much less fatal outbreaks. Given the uncertain trajectory of the (exit from the) public health crisis, there is similar uncertainty about the necessary containment measures which will impact the economic recovery. On the one hand, this speaks for maintaining the support for longer until the recovery process has clearly taken off, thus also avoiding cliff effects that can result in widespread insolvency and unemployment; on the other hand, this calls for a more differentiated approach in support going forward, focusing on sectors that are most affected by continuing containment measures and where persistence effects in consumption will imply a slower recovery process. Most importantly, however, this calls for erring on the side of maintaining support for too long rather than terminating too early.

It is clear, however, that as we proceed towards an exit from the public health crisis and thus, towards broader-based economic recovery, the weights on the reallocation process become stronger compared to the weights on the survival/hysteresis arguments. This also implies that now is a good moment to properly prepare for such exit strategy; critically, focusing on the inter-linkages between phasing out the different support measures and focus on institutional cooperation.

To illustrate this tension more specifically, we will discuss some specific policies and their interlinkages. We will discuss phasing out of the main supervisory and regulatory support measures in a chronological order that highlights the interdependence between them and with other support measures. We will start with the measure that we think should be reversed first (loan classification rules and moratoria) and end with the ones that we think should be phased out last (capital relief).

### **3.1. Returning to standard loan classification rules and remodulation of moratoria**

In March 2020, loan loss classification standards were relaxed, with supervisors exercising flexibility regarding the classification of debtors as “unlikely to pay” and the consequent request in terms of specific provisions when such loans were subject to government-initiated interest payment moratoria. In addition, supervisors provided guidance to mitigate volatility in banks’ regulatory capital and financial statements stemming from IFRS9 accounting rules. According to ESRB (2021), “European regulators and supervisors have advised banks to make use of the flexibility provided by standards and take a long-term view in assessing which creditors are in a good position to recover from the crisis.” The goal of these measures was to avoid excessive volatility of loan loss provisioning that would result in excessive procyclicality of regulatory capital.

At the same time, however, banks needed to start accumulating adequate provisions in order to prepare for the end of the moratoria when potential “cliff effects” in loan deterioration may emerge. Despite the flexibility granted, therefore, and in accordance with IFRS9 rules, banks were required to accumulate general provisions in response to the deterioration of the macroeconomic scenario and supervisors intensified their oversight on banks’ handling of credit risk. The key question is how to achieve the right balance between supporting borrowers and banks’ incentives. Granting banks flexibility concerning loan classifications may lead to opaqueness in banks’ balance sheet concerning their true asset quality if the lack of payments due to moratoria masks solvency problems rather than simply liquidity problems. In addition, if banks do not recognize and provision adequately for loan losses, they may be induced to continue unviable relationships. Specifically, facing the risk of large losses if borrowers and loans have to be downgraded, banks have incentives to evergreen loans, i.e., rolling over non-performing loans rather than recognising losses. These incentives are exacerbated by low interest rates, as interest payments are easier to make than principal repayment (which can be rolled over). Such evergreening can result in zombification, i.e., an increasing role of non-profitable and non-viable firms in an economy. As shown by the literature (Adalet McGowan et al., 2018), this has negative implications not only for average firm growth but also negative growth implications for non-zombie firms (who might be undercut in pricing by zombie firms and who cannot expand at the expense of zombie firms. It also prevents the entry of new innovative firms that might contribute to overall (productivity) growth in an industry or sector. Thus, as suggested also in Laeven et al., (2020), in particular as the pandemic evolves and there is more visibility on the longer-term viability of borrowers, supervisory authorities need to ensure that banks provision adequately for loan losses on a forward-looking basis. This should help reduce zombie lending as it removes the incentive to hold on to these loans (Bonfim et al., 2020).

Proper loan classification also contributes to increase transparency of banks’ balance sheets and asset quality, which is important also to restore proper market discipline. To achieve the objective of post-pandemic bank transparency, reverting to normal loan classification and provisioning standards has to be accompanied by complementary measures. First, the tendency for evergreening and thus support

for zombie borrowers is more pronounced for less capitalised banks, which puts a premium on ensuring sufficiently high capital buffers. Second, a rigorous asset quality review and stress testing can be an important tool to counter incentives towards evergreening, as well as to better gauge the capital trajectory. Third, incentives might have to be set to facilitate restructuring and insolvency proceedings for overindebted businesses, as we discuss in Box 1. This also calls for enhancing insolvency and bankruptcy procedures, as evergreening incentives are stronger in environments with inefficient insolvency framework.

The objective of bank transparency also implies a certain sequencing of supervisory actions and, critically, a coordinated approach by fiscal and supervisory authorities. Certainly, proper loan classifications for loans under moratoria is more challenging for banks as they miss information on the payments. Thus, in a first step, loan moratoria should be phased out to make bank monitoring more effective and NPL recognition possible. This implies both moratoria imposed by governments and by bank associations. Alternatively, one can consider a partial phase-out, limiting moratoria to sectors that are still subject to containment measures (e.g., international tourism). Overall, bank balance sheet transparency needs to be restored as it is important to enhance banks' ability to raise private funds when ECB funding and liquidity support will be phased out.

### **3.2. Exit from guarantees and corporate insolvency**

Governments have provided guarantees for firms affected by the pandemic and containment policies as well as provided other support measures, such as grants or subsidies under "Kurzarbeit" (short-time work) arrangements. These guarantees have different maturities and conditions as discussed above. While useful to support lending during the pandemic, the presence of guarantees may again encourage banks to lend to non-viable firms with the risk of zombification. This may happen at the issuing of a guaranteed loan as banks may be tempted to relax their underwriting standards and screening procedure, and at the end, when guaranteed loans mature as banks may have not performed proper monitoring and may have distorted incentives concerning potential loan restructuring and workout and thus resulting in roll-over to avoid booking losses.

As a consequence, policy makers should consider adjusting support policies. One example are conditions for loan guarantees. While initially the main condition was that borrowers had to be in good standing pre-pandemic, one could consider adding conditionality as the pandemic evolves or at the renewal stage, such as a business plan and financial projections that show that the borrowing firm is still viable. In sum, guarantees should be limited to borrowers that can show clear negative effects of having to pay, while at the same time clear positive recovery projections. An alternative approach would be maintaining support only for industries under prolonged confinement (e.g., travel industry). Such adjustments to support policies could be a first step towards exit policies from support programmes. While the two examples mentioned so far concern fiscal policy, such adjustments (which can be seen as partial exits) would have implications for bank regulators and supervisors as they would have implications for banks' balance sheets and thus would require complementary actions.

By the same token, the exit from guarantee schemes should be carefully designed. In fact, as argued by Gobbi et al. (2020), the collateral values are likely to fall when guarantees are lifted, potentially encouraging loan foreclosures. These considerations would call for a smooth phasing out of government credit guarantees, to avoid cliff effects on bank lending. At the same time, incentives for zombie lending and the associated risks of cliff effects would be much reduced if firms were financed with equity instead of debt, also counteracting debt overhang. Therefore, the phasing out of credit guarantees could be usefully complemented with measures that promote the use of equity (or equity-like) instruments to reduce the excessive reliance on debt-based instruments (Laeven et al., 2020; Boot et al., 2020).

## Box 1: Corporate insolvencies post-pandemic

Public support measures in the form of guarantees and loans have resulted in an increasing debt burden for firms, which even in a prolonged period of low interest rates, will result in a large share of overindebted firms. While some firms will be viable but overindebted, others will be unviable. Corporate insolvency regimes might not be able to handle a large number of firms requiring restructuring or liquidation. At the same time and as already discussed above, banks might face perverse incentives to 'extend-and-pretend', resulting in zombification.

There are several ways to address the overindebtedness, on the macro- and micro-level. First, governments could convert a share of guaranteed loans into or complement them with grants or other types of equity or quasi equity instruments. More generally, the use of equity instruments would be useful in this context and development banks have a potential role to play (e.g., Boot et al., 2020). Such a measure, however, might be untargeted, and more targeted support for viable firms might have higher allocative efficiency and be less costly, though it might impose a costly burden on the government in terms of 'picking winners'. Public agencies such as public development banks in charge of loan guarantees may not be the best placed to oversee debt restructuring (e.g., with their own balance sheets exposed, they may be inclined to 'extend-and-pretend' distortions in their actions) (Becker et al., 2020).

Given the bank-based nature of Europe's financial system and given that banks are the largest creditor for most smaller enterprises, any corporate restructuring would have to closely involve banks, making sure that banks face appropriate incentives. One option would be decentralised bank-based restructuring; while banks are in the best position to do so, they might face barriers in the form of overwhelmed court systems as well as be forced to divert resources from the necessary funding of new and successful corporations and thus supporting the economic recovery process. While out-of-court restructuring might be available in some jurisdictions, others might require legislation allowing for temporary swifter out-of-court restructuring processes. An alternative option would be national or even European asset management companies (AMC); this would have the advantage of centralising restructuring and possibly exploiting economies of scale. While such AMCs have been successful in some European countries, they typically involved mortgage loans, while problem loans during the current crisis will be concentrated in the corporate and small business sector, so are of rather heterogeneous character, thus not allowing benefits from scale or scope economies and – unlike real-estate-based loans – might not increase in value after the crisis.

### 3.3. Return to 'standard' regulatory requirement and resolution planning

The broad support measures both by fiscal and regulatory authorities have paused the usual loss recognition process. This can be justified by both the high degree of uncertainty on future viability of borrowers and the aim of avoiding hysteresis, as discussed above. However, as these support measures are being phased out and as complementary supervisory actions (asset quality review and stress testing) are being undertaken, losses will emerge on banks' balance sheets.

While this might not imply widespread bank failures, one can foresee a scenario where several banks are not only undercapitalised (relative to standard capital requirements or at least under a stress scenario) but will not be able to raise additional capital on the market. This will require intervention by resolution authorities on the national or European level. While post-GFC, all EU member states have introduced bank resolution frameworks in line with the Bank Recovery and Resolution Directive (BRRD) and there is coordination mechanism for the banking union in the form of SRM) it has been widely recognised that the banking union is not complete and that resolution frameworks need reforms, especially for smaller and mid-sized banks, which currently can only be liquidated or – under

precautionary recapitalisation - be supported with government resources, in the absence of a positive public interest assessment. Allowing resolution and restructuring mechanisms for such banks, including allowing for a constructive role for deposit guarantee schemes and for liquidity in resolution, has been suggested as an important step in the reform of the BRRD. It is doubtful, however, that such necessary reforms can be implemented in time for possible post-pandemic bank fragility.

Authorities have to consider the possibility that the current framework will not be sufficient to address bank fragility, especially if bank failures are geographically concentrated. Close cooperation in scenario and contingency planning between supervisory and resolution authorities as well as with the European Commission (given possible implications for state aid rules) is therefore called for. Such cooperation should take place on the national level (between national competent authorities, designated authorities, resolution authorities and – very relevant – deposit guarantee schemes. It should also take place on the European level, between SSM and SRB, but also in cooperation with the European supervisory authorities, the European Systemic Risk Board and the European Commission.

As a new round of stress tests will be undertaken in summer 2021, it is important that the necessary structures are in place to address bank fragility exposed in the findings of the stress tests. The publication of the stress tests will potentially trigger market reactions and might force supervisory reactions. Being ready for such reactions in the form of coordinated responses will be critical.

### **3.4. Exit from capital relief and dividend restrictions**

As discussed above, in March/April 2020, supervisory authorities granted capital and liquidity flexibility. In particular, banks have been granted the possibility to make use of the capital buffers and to operate temporarily below the normal liquidity requirements. At the same time, banks were asked not to distribute dividends for 2019 and be very prudent in their 2020 distribution policies. These measures have the intention to preserve capital, so that banks can better sustain lending to the economy until more visibility on the evolution of the pandemic and the effect on banks' asset quality will materialize.

Despite banks having made limited use of the flexibility in terms of capital and liquidity requirements so far, a crucial question is when to ask banks to rebuild capital buffers and over which period. Replenishing capital might require, in fact, banks to raise fresh equity on the market; an undertaking, which is made more difficult by the current profit distribution restrictions. It follows that, as much as there are arguments for combining capital relief and restrictions on profit distribution, there are strong arguments to phase them out in combination.<sup>8</sup>

As supervisors have announced the phasing out of capital relief measures, it is therefore important to return to the usual market-driven profit distribution process, subject to the SREP, which in turn will be informed by the results of the stress tests in summer 2021.

## **4. CONCLUDING REMARKS**

Designing proper exit strategy requires judgment as well as coordination among different, national and international, institutions. In the following, we summarise our discussion and point to some key steps in terms of sequencing.

In designing the exit strategies, restoring bank balance sheet transparency should be a first-order objective. Having this in mind, borrower relief measures such as moratoria should be phased out ahead

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<sup>8</sup> It is also important to note that bank equity is private capital whose providers expect to be rewarded for their risk-taking. Restricting property rights of banks' shareholders beyond the immediate emergency situation would not only put banks at a significant disadvantage to other industries and sectors. It would also undermine the balance between regulators and bank management, where the former have stronger rights vis-à-vis the latter as the solvency position of individual banks deteriorates, but not blanket rights to intervene in shareholders' property rights.

of phasing out other measures, as first important step. This is important to re-establish the proper screening/monitoring incentives, favour NPL recognition and, therefore, promote adequate loan loss provisioning. A second important step to be taken would be the enforcement of standard loan classification rules.

Doing this would reduce the risk of credit misallocation (including zombification) that is likely to rise if generalised borrower relief measures are in place for too long. Moreover, it would entail the possibility to measure banks' asset quality properly, which is a precondition for banks to assess the amount of capital at risk, and thus, the amount of capital buffer needed to absorb credit losses. As opaque balance sheets increase bank funding constraints, making it harder for investors to price bank credit risk and exert market discipline, restoring bank transparency would also make it possible for banks to access capital markets once the extraordinary monetary policy measure will be removed.

Of course, unwinding support measures requires graduality and flexibility, as certain firms or industries may need prolonged forms of support, depending on the evolution of the pandemic. Any additional or prolonged support needs, however, to be designed accurately in order to mitigate the risk of moral hazard on the part of businesses and evergreening on the part of banks. If borrower support measures cannot be phased out completely, moving from blanket support to more targeted support would be an alternative important first step.

After the crisis, certain banks may display markedly reduced capital buffers and certain firms may be found unviable. Creative destruction could follow, with better capitalised banks or firms being in the position to purchase the weakest institutions. All the process would require not only cooperation at different level and across multiples institutions, but also calls for a flexible use of national and European bank resolution schemes and national insolvency frameworks, as the weakest banks may require the SRB's interventions, while the weakest firms may need to be restructured or liquidated. Preparing for such scenarios should be a first-order priority before the publication of the stress test results in mid-2021, even though their implementation is not to be considered until later in 2021 or in 2022.

Asking banks to rebuild their capital buffers, released in the early stages of the pandemic should come towards the end of the exit process, with a clear schedule. Announcing such a schedule should also be complemented with a move from blanket restrictions on profit distribution to a bank-by-bank approach.

Whichever the exit strategy, this needs to be communicated in a clear and timely manner. This would provide banks sufficient time and space of manoeuvre, and enable market participants (investors, market analysts, and rating agencies) to take actions accordingly.

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Designing exit strategy requires judgment, coordination among different institutions, and graduality. Restoring banks' balance sheet transparency is a first-order objective. To this end, borrower relief measures should be phased out ahead of the other measures. Relaxation of loan classification and provisioning policies can be lifted in a second stage. The last one to be unwound would be capital relief initiatives. To provide banks time and space of manoeuvre, exit strategies needs to be communicated in a clear and timely manner.

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